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TRANSCRIPT OF RECORD

Supreme Court of the United States

OCTOBER TERM, 1932

No. 448

PETROLEUM EXPLORATION, PETITIONER,

vs.

DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT

PETITION FOR CERTIORARI FILED OCTOBER 12, 1932

CERTIORARI GRANTED NOVEMBER 14, 1932

(37,145)

(37,145)

SUPREME COURT OF THE UNITED STATES

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DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT

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JUDD & DETWEILER (INC.), PRINTERS, WASHINGTON, D. C., DECEMBER 6, 1932

TRANSCRIPT OF RECORD

Docket No. 43480.

Petroleum Exploration
vs.
Commissioner of Int. Rev.

For Taxpayer: Leland E. Fiske, C. P. A.; T. J. Reilly, Esq.; Robert Ash, Esq.; For Commissioner: E. Meacham, Esq., C. E. Lowery, Esq.

DOCKET ENTRIES.

1929
Apr. 4—Petition received and filed. Taxpayer notified. (Fee paid.)
" 5—Copy of petition served on General Counsel.
May 27—Answer filed by G. C.
" 29—Copy of answer served on taxpayer—general calendar.
1930
Mar. 22—Notice of appearance of Robert Ash and T. J. Reilly as counsel for taxpayer filed.
June 6—Application for order to take depositions filed by taxpayer.
" 9—Motion to withdraw application to take depositions filed by taxpayer. 6-12-30 Granted.
June 10—Objection to issuance of order to take depositions filed by G. C.
Sept. 12—Motion to consolidate with dkt. 49339, filed by taxpayer. 9-29-30 Granted.
Oct. 4—Hearing set Dec. 2, 1930.
" 29—Notice to send all papers to Mr. Robt. Ash filed by L. E. Fiske.
Nov. 1—Agreed statement of facts filed.
Dec. 2—Hearing had before Judge Marquette, Div. 1. Submitted—assigned to Mr. Trussell, Div. 6. Briefs due Jan. 5, 1931.

" 31—Motion for extension to Feb. 4, 1931, to file brief filed by G. C. 1-5-31 Granted both parties.

1931
Jan. 2—Transcript of hearing 12-2-30 filed.
" 5—Brief filed by taxpayer.
" 31—Brief filed by G. C.
Apr. 24—Motion to supplement brief filed by taxpayer. 4-27-31 Granted.
June 29—Findings of facts and opinion rendered—Mr. Trussell (6). Judgment will be entered rule 50.
July 1—Notice of settlement filed by taxpayer. 7-8-31 Copy served.
" 1—Motion to recall decision, filed by G. C.
" 7—Hearing set July 22, 1931, on settlement.
" 10—Hearing set July 22, 1931, on motion.
" 22—Hearing had before Mr. Smith, Div. 5, on settlement rule 50, & motion. Referred to Mr. Trussell, Div. 6. (Settlement not contested.)
Aug. 5—Transcript of hearing 7-22-31 filed.
" 27—Order denying motion to reconsider findings of facts and opinion, and decision entered.

1932
Feb. 9—Petition for review to U. S. Cir. Ct. of Ap. (4) with assignments of error, filed by G. C.
" 10—Proof of service filed.
Apr. 2—Certified copy of order extending time to May 9, 1932, to complete & transmit record filed.
" 28—Praecipe filed. Proof of service thereon.

(2) Docket No. 49339.

Petroleum Exploration
vs.
Commissioner of Int. Rev.

For Taxpayer: Leland E. Fiske, C. P. A.; Robert Ash, Esq., T. J. Reilly, Esq.; For Commissioner: E. Meacham, Esq., C. E. Lowery, Esq.

DOCKET ENTRIES.

1930
June 23—Petition received and filed. Taxpayer notified. (Fee paid.)
" 24—Copy of petition served on General Counsel.
Aug. 5—Answer filed by G. C.
" 12—Copy served, assigned general calendar.
Sept. 12—Motion to consolidate with dkt. 43480, filed by taxpayer. 9-29-30 Granted.
" 19—Notice of the appearace of Robert Ash, T. J. Reilly and Leland E. Fiske, counsel for taxpayer, filed.
Oct. 4—Hearing set Dec. 2, 1930.
" 29—Notice to mail future notices to Robert Ash, Esq., filed by Leland E. Fiske.
Nov. 1—Agreed statement of facts filed. See 43480.
Dec. 2—Hearing held before J. J. Marquette, Div. 1. Submitted. Assigned to Mr. Trussell. Briefs due Jan. 5, 1931.
Dec. 31—Motion for extension to 2-4-31 to file brief filed by G. C. 1-5-31 Granted both parties.
1931
Jan. 5—Brief filed by taxpayer.
" 2—Transcript of hearing of Dec. 2, 1930, filed.
" 31—Brief filed by G. C.
Apr. 24—Motion for leave to supplement its brief, embodying supplement filed by taxpayer. Grated, 4-27-31.
June 29—Findings of fact and opinion rendered, Sumner L. Trussell, Div. 6. Judgment will be entered pursuant to Rule 50.
July 1—Motion to recall decision filed by G. C.
" 1—Notice of settlement filed by taxpayer. Copy served 7-8-31.
" 10—Hearing set July 22, 1931, on motion.
" 22—Hearing had before Mr. Smith, Div. 5 on settlement under Rule 50 and motion to recall decision. (Settlement not contested.) Referred to Mr. Trussell for decision.
Aug. 5—Transcript of hearing July 22, 1931, filed.
" 27—Decision entered, Mr. Trammell, Div. 2.

1932
Feb. 9—Petition for review by U. S. Cir. Ct. of Ap. (4) with assignments of error filed by G. C.
" 10—Proof of service filed.
Apr. 2—Certified copy of order enlarging time to May 9, 1932, to transmit and to complete record filed.
" 28—Praecipe filed. Proof of service thereon.

PETITION.

(3) Filed Apr. 4, 1929.

UNITED STATES BOARD OF TAX APPEALS.

Petroleum Exploration, Petitioner,
vs.
Commissioner of Internal Revenue, Respondent.
Docket No. 43480

The above named petitioner hereby petitions for a re-determination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency (IT:AR:G-5:AGS:60D) dated March 16, 1929, and as a basis of its proceeding alleges as follows:

1. The petitioner is a corporation organized under the Laws of the State of Maine, on September 25, 1916, with principal office at Sistersville, West Virginia. The petitioner is the parent company of the following subsidiaries:

Petroleum Purchasing Company, organized under the laws of Delaware on April 1, 1924, with principal office at Sistersville, West Virginia.

Western Petroleum Exploration, organized under the laws of Maine, on June 7, 1921, with principal office at Sistersville, West Virginia.

2. The notice of deficiency (a copy of which is attached and marked Exhibit A) was mailed to the petitioner on March 16, 1929.

3. The taxes in controversy are income taxes for the calender years 1925 and 1926, and amount to $17,302.50.

4. The determination of tax set forth in the said notice of deficiency is based upon the following errors:

(a) The Commissioner has erred in refusing to add to his depreciation schedules, for the year 1925, for the parent company, the cost of productive oil wells capitalized on the books, and to allow a deduction for depreciation thereon. The Commissioner's depreciation allowance for 1925 on lease equipment is $82,826.35, whereas the correct allowance should be $89,369.57.

(b) The Commissioner has erred in refusing to add to his depreciation schedules, for the year 1926, for the parent company, the cost of productive oil wells capitalized on the books, and to allow a deduction for depreciation thereon. The Commissioner's depreciation allowance for 1926 on lease equipment is $68,105.24, whereas the correct allowance should be $78,192.46.

(4)

(c) The Commissioner erred in refusing to allow as a bad debt deduction, that part of a loan from the parent company to Southern Petroleum Exploration, a Delaware corporation, which was determined to be worthless and charged off during the year 1926.

5. The facts upon which the petitioner relies as the basis of this proceeding are as follows:

(a) During the years 1925 and 1926 Petroleum Exploration drilled a number of productive oil wells, and charged the cost of such wells to capital account. In preparing "Form O" for 1925 and 1926, the cost of these wells was added to the equipment schedules, and depreciation computed thereon. The Commissioner, however, insists that the cost of these wells should be added to the leasehold schedules and returned as depletion. By such action the Commissioner penalizes the petitioner, inasmuch as depletion has been computed on a percentage basis, 27½ per cent of gross income, or 50 per cent of net income, and is not in any way increased by the addition of the drilling costs to the depletion schedules; whereas, when such drilling costs are added to the depreciation schedules, an additional depreciation deduction does result.

(b) Petroleum Exploration owns 75 per cent of the capital stock of Southern Petroleum Exploration, a Delaware Corporation. During the years 1925 and 1926, Petroleum Exploration made a *bona fide* loan to Southern Petroleum Exploration, for the purpose of prospecting for oil, totaling $117,267.80. A proportionate loan of one-third of this amount was made at the same time by the holders of the other 25 per cent of the stock. At the end of 1926, Southern Petroleum Exploration had lost the sum of $62,613.24 in drilling dry holes. Of this sum, $25,000.00 was the paid in capital of Southern Petroleum Exploration; the balance, amounting to $37,613.24, was from funds loaned by Petroleum Exploration and the minority stockholders of Southern Petroleum Exploration. There were no assets from which the loss of $37,613.24 could be repaid, hence it became a bad debt in the hands of the lenders during 1926. Petroleum Exploration's share was 75 per cent, or $28,209.93, and was duly charged off during 1926 as the part of its loan to Southern Petroleum Exploration which became worthless during the taxable year.

6. Wherefore the petitioner prays that the Board may hear the proceeding and prays for relief from the deficiency asserted by the respondent on the following and each of the following particulars:

(a) That the Board find that the capitalized cost of drilling productive oil wells should be returned as depreciation and not as depletion and that the depreciation allowances for Petroleum Exploration made on such wells and associated equipment for 1925 and 1926 should be $89,369.57 and $78,192.46 respectively.

(b) That the Board find that the part of the loan, made by Petroleum Exploration to Southern Petroleum
(5) Exploration, which became worthless and was charged off in 1926, amounted to $28,209.93.

(c) And such other and further relief as the nature of the case may require.

LELAND E. FISKE, C. P. A.,
Counsel for Petitioner,
216 Atlas Life Bldg.,
Tulsa, Okla.

STATE OF WEST VIRGINIA,
County of Tyler, ss.

E. A. Durham, being duly sworn, says that he is the president of the above named petitioner; that he is duly authorized to verify the foregoing petition; that he has read the foregoing petition, or had same read to him, and is familiar with the statements contained therein, and that the facts stated are true, except as to those facts stated to be upon information and belief, and those facts he believes to be true.

E. A. DURHAM.

Subscribed and sworn to before me this 2 day of April, 1929.

J. E. FETTY,
Notary Public.

(Notary Seal).

My commission expires Nov. 8, 1937.

EXHIBIT A.

Treasury Department
Washington

(6) March 16, 1929.

Office of
Commissioner of
Internal Revenue.

Address Reply to
Commissioner of
Internal Revenue
and Refer to
IT:AR:G-5:AGS:60D.

Petroleum Exploration,
Trico Bldg.,
Sistersville, West Virginia.

Sirs:

In accordance with Section 274 of the Revenue Act of 1926, you are advised that the determination of your tax liability for the years 1925 and 1926 discloses a deficiency of $17,302.50, as shown in the statement attached.

The section of the law above mentioned allows you to petition the United States Board of Tax Appeals within sixty days (not counting Sunday as the sixtieth day) from the date of the mailing of this letter for a redetermination of your tax liability.

However, if you do not desire to petition, you are requested to execute the inclosed Form 866 and forward both original and duplicate to the Commissioner of Internal Revenue, Washington, D. C., for the attention of IT:C:P-7. The signing of this agreement form will expedite the closing of your return by permitting an early assessment of any deficiencies and preventing the accumulation of interest charges, since the interest period terminates thirty days after filing the agreement form, or on the date assessment is made, whichever is earlier; Whereas, if no agreement is filed, interest will accumulate to the date of the assessment of the deficiencies.

Respectfully,

D. H. BLAIR, Commissioner,
By C. B. ALLEN,
Deputy Commissioner.

Inclosures:
Statement
Form 866-C. R.
Form 882.
Schedules 1 to 9, inclusive.

(7) Exhibit A Continued.

Statement.

IT:AR:G-5
AGS-60D

Parent	Years	Form
Petroleum Exploration Sistersville, West Virginia	1925	1120 Consolidated
	1926	1120 Consolidated
Subsidiary Companies:		
Western Petroleum Exploration Sistersville, West Virginia.	1925 1926	
Petroleum Purchasing Company Sistersville, West Virginia	1925 1926	

Tax Liability

Petroleum Exploration

Year	Corrected Tax Liability	Tax Previously Assessed	Deficiency
1925	$40,146.64	$29,884.38	$10,262.26
1926	53,565.68	46,525.44	7,040.24
Total	$93,712.32	$76,409.82	$17,302.50

Your protest dated January 17, 1929, Revenue Agent's report covering the years 1925 and 1926 and Bureau letter dated December 22, 1928, have been made the basis of this audit.

In determining your tax liability as stated herein, careful consideration has been given to the statements set forth in the following claims:

Kind	Amount	Year	Date Filed
Refund	$2,066.30	1925	March 3, 1928
Refund	781.35	1926	March 3, 1928

A carbon copy of this letter has been mailed to Leland E. Fiske, in accordance with the authorization contained in your power of attorney running to him which is on file in this office.

Consents which will expire December 31, 1929, are on file for the years 1924 and 1925.

(8) Exhibit A Continued.

-1-

Petroleum Exploration. Year Ended December 31, 1925.

Schedule 1

Net Income

Net income as disclosed by return	$212,774.80
As corrected	211,202.61
Net adjustment	$ 1,572.19

Unallowable deductions and additional income:		
(a) Expense	$ 865.16	
(b) Depreciation	3,360.57	
Total		$ 4,225.73
Nontaxable income and additional deductions:		
(c) Depletion	$1,271.52	
(d) Losses	4,526.40	
Total		5,797.92
Net adjustments as above		$ 1,572.19

Explanation of Items Changed

(a) Expense		$ 865.16

Legal costs to validate titles are held to be a part of the cost of the particular property and not an allowable deduction from gross income.

(b) Depreciation		$ 3,360.57
Excessive depreciation of Miscellaneous Assets	$ 2,474.50	
Excessive depreciation of Lease Equipment	886.07	
Total		$ 3,360.57

For further explanation see Schedules F and G attached to a Revenue Agent's report for the year 1925, a copy of which has been furnished to you.

(9) Exhibit A Continued.

-2-

Petroleum Exploration. Year Ended December 31, 1925.

Schedule 1 Continued.

Explanation of Items Changed
(continued)

(c) Depletion		$ 1,271.52

Depletion allowable	$302,012.87	
Depletion deducted	300,741.35	
Additional depletion allowable		$ 1,271.52

For depletion allowable see the attached Valuation Report.

(d) Losses		$ 4,526.40
Increased loss on Carbon Black plant		$ 7,709.83
Decrease in loss on casings		3,183.43
Losses allowable		$ 4,526.40

The loss on Carbon Black plant has been increased to take care of a retaining wall which is of no further value when the Carbon Black plant is abandoned. Losses on casings which are applicable to prior years are not an allowable deduction for the current year.

Schedule 2

Western Petroleum Exploration.

Net Income

Net loss as disclosed by return		$ 77,842.70
As corrected—net loss		287.48
Net adjustments		$ 77,555.22
Unallowable deductions and additional income:		
(a) Depletion	$ 1,228.11	
(b) Losses	77,934.04	
Total		$ 79,162.15
Additional deduction:		
(c) Depreciation		1,606.93
Net adjustment as above		$ 77,555.22

(10) Exhibit A Continued

–3–

Petroleum Exploration
Western Petroleum Exploration.

Year ended December 31, 1925.

Schedule 2
(continued)

Explanation of Items Changed.

(a) Depletion		$ 1,288.11
Depletion deducted	$11,530.32	
Depletion allowable	10,302.21	
Depletion disallowed	$ 1,228.11	

See the attached Valuation Report for depletion allowable.

(b) Losses	$ 77,934.04
Loss on Syndicate account.	

The Bureau holds that this loss is not determinable.

(c) Depreciation	$ 1,606.93

This item is additional depreciation allowable as disclosed by Exhibit F of Revenue Agent's report for 1925.

Schedule 3

Petroleum Purchasing.

Net Income

Net Income as disclosed by return	$ 94,947.77
As corrected	97,912.84
Net adjustment	$ 2,965.07
Unallowable deduction:	
(a) Inventory	$ 2,977.05
Additional deduction:	
(b) Depreciation	11.98
Net adjustments as above	$ 2,965.07

(11) Exhibit A Continued

-4-

Petroleum Exploration
Petroleum Purchasing

Year ended December 31, 1925.

Schedule 3
(continued)

Explanation of Items Changed

(a) Inventory		$ 2,977.05
Decrease in opening inventory	$2,579.57	
Decrease in closing inventory	2,397.48	
Total increase to income	$2,977.05	

See Exhibit G of Revenue Agent's report for the year 1925, a copy of which has been furnished to you.

(b) Depreciation $ 11.98

See Schedule F of the above mentioned report.

Schedule 4

Net income as corrected:	
Petroleum Exploration	$211,202.61
Petroleum Purchasing Company	97,912.84
Total	$309,115.45
Net losses as corrected:	
Western Petroleum Exploration	287.48
Aggregate net income	$308,827.97
Adjustments:	
Add: Intercompany profit in inventory December 31, 1924	26,204.28
Total	$335,032.25
Deduct: Intercompany profit in inventory December 31, 1925	26,211.97
Consolidated net income	$308,820.28

(12) Exhibit A Continued

-5-

Petroleum Exploration Year ended December 31, 1925

Schedule 5

Computation of Tax

Income Tax

Net income for taxable year subject to tax at 13 per cent	$308,820.28
Total tax assessable	$ 40,146.64
Total previously assessed	29,884.38
Additional tax to be assessed	$ 10,262.26

Schedule 6

Year ended December 31, 1926.

Net Income

Net income as disclosed by return		$289,630.37
As corrected		336,776.75
Net adjustment		$ 47,146.38
Unallowable deductions and additional income:		
(a) Depreciation	$ 1,938.16	
(b) Bad debts	46,959.93	
Total		$ 48,898.09
Nontaxable income and additional deductions:		
(c) Depletion	$ 713.92	
(d) Loss on Autos and Fixtures	854.80	
(e) Casing lost	182.99	
Total		1,751.71
Net adjustment as above		$ 47,146.38

(13) Exhibit A continued.

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Petroleum Exploration Year ended December 31, 1926.

Schedule 6
(continued)

Explanations of Items Changed.

(a)	Depreciation			$ 1,938.16
	Depreciation deducted		$79,403.26	
	Depreciation allowable, lease equipment	$68,105.24		
	Depreciation allowable, miscellaneous assets	9,359.86	77,465.10	
	Depreciation disallowed		$ 1,938.16	
(b)	Bad debts			$ 46,959.93

This is 75 per cent of the amount of the deficit of the Southern Petroleum Exploration Company, which you deduct as a bad debt. The Bureau holds that the amount has not been determined as a bad debt.

(c)	Depletion			$ 713.92
	Depletion allowable		$277,900.70	
	Depletion deducted		277,186.78	
	Additional depletion allowable		$ 713.92	
(d)	Losses on auto and Fixtures			$ 854.80

The losses are allowed as disclosed in Exhibit P of Revenue Agent's report for 1925.

(e)	Casing lost	$ 182.99

Casing lost and abandoned were charged to Reserve for depreciation of lease equipment is now allowed as a deduction from gross income.

(14) Exhibit A Continued.

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Petroleum Exploration Year ended December 31, 1926.
Western Petroleum Exploration

Schedule 7

Net Income

Net income as disclosed by return		$ 47,841.41
As corrected		55,197.01
Net adjustment		$ 7,355.60
Unallowable deductions and additional income:		
(a) Profit on sale of leases	$13,994.25	
Nontaxable income and additional deductions:		
(b) Depletion	6,638.65	
Net adjustment as above		$ 7,355.60

Explanation of Items Changed

(a) Profit on sale of leases $ 13,994.52

Profit on sale of leases has been increased by the depletion computed on cost for the year 1926.

(b) Depletion $ 6,638.65

Depletion has been increased to the proper amount on the cost basis:

Depletion on Cost	$13,994.25
Depletion deducted	7,355.60
Additional depletion	$ 6,638.65

Schedule 8

Petroleum Purchasing Company.

Net Income

Net Income as disclosed by return	$ 31,795.63
As corrected	28,330.72
Net adjustment	$ 3,464.91

(15) Exhibit A Continued.

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Petroleum Exploration Year ended December 31, 1926.
Petroleum Purchasing Company.

Schedule 8
(continued)

Additional income:	
(a) Inventory	$ 3.39
Additional deduction:	
(b) Depreciation	3,468.30
Net adjustment as above	$ 3,464.91

Explanation of Items Changed

(a) Inventory $ 3.39

This adjustment is disclosed in Revenue Agent's report for the year 1926, Exhibit B, a copy of which has been furnished to you.

(b) Depreciation $ 3,468.30

See Exhibit F of the above mentioned report.

Schedule 9

Petroleum Exploration.

Net Income as corrected:	
Petroleum Exploration	$336,776.75
Western Petroleum Exploration	55,197.01
Petroleum Purchasing Company	28,330.72
Total	$420,204.48
Deduct:	
Intercompany profit in inventories	23,521.64
Consolidated net income	$396,782.84

Schedule 10

Computation of Tax

Income Tax

Net Income for taxable year subject to tax at 13½ per cent	$396,782.84
Total tax assessable	$ 53,565.68
Total previously assessed	46,525.44
Additional tax to be assessed	$ 7,040.24

ANSWER.

(16) Filed May 27, 1929.

UNITED STATES BOARD OF TAX APPEALS.

Petroleum Exploration, Petitioner,
vs.
Commissioner of Internal Revenue, Respondent.
} Docket No. 43480

The Commissioner of Internal Revenue by his attorney, C. M. Charest, General Counsel Bureau of Internal Revenue, for answer to the petition of the above named taxpayer, admits and denies as follows:

1. Admits the allegations contained in Paragraph 1.

2. Admits the allegations contained in Paragraph 2.

3. Admits that the taxes in controversy are income taxes for the calendar years 1925 and 1926, and that the notice of deficiency shows deficiencies in tax for said years in the respective amounts of $10,262.26 and $7,040.24.

4 (a), (b) and (c). Denies that the Commissioner has committed errors as alleged in subparagraphs (a), (b) and (c) of Paragraph 4.

5 (a) and (b). Denies the allegations contained in subparagraphs (a) and (b) of Paragraph 5.

6. Denies generally and specifically each and every allegation in taxpayer's petition not hereinbefore admitted, qualified, or denied.

Wherefore, it is prayed that the taxpayer's appeal be denied.

(Signed) C. M. CHAREST,
General Counsel,
Bureau of Internal Revenue.

Of Counsel:

EUGENE MEACHAM,
C. E. LOWERY,
Special Attorneys,
Bureau of Internal Revenue.

PETITION.

(17) Filed June 23, 1930.

UNITED STATES BOARD OF TAX APPEALS.

Petroleum Exploration, Petitioner,
vs.
Commissioner of Internal Revenue, Respondent.
Docket No. 49339

The above named petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency (IT:AR:G-3:CB) dated June 13, 1930, and as a basis of its proceeding alleges as follows:

1. The petitioner is a corporation organized under the Laws of the State of Maine, on September 25, 1916, with principal office at Sistersville, West Virginia. The petitioner is the parent company of the following subsidiary;

Petroleum Purchasing Company, organized under the laws of Delaware on April 1, 1924, with principal office at Sistersville, West Virginia.

2. The notice of deficiency (a copy of which is attached and marked Exhibit A) was mailed to the petitioner on June 13, 1930.

3. The taxes in controversy are income taxes for the calendar year 1927 and amount to $4,404.21.

4. The determination of tax set forth in the said notice of deficiency is based upon the following errors:

(a) The Commissioner has erred in refusing to add to his depreciation schedules, for the year 1927, for the parent company, the cost of productive oil wells capitalized on the books of account, and to allow a deduction for depreciation thereon. The Commissioner's depreciation allowance for 1927 on lease equipment is $66,015.91, whereas the correct allowance should be $75,427.20.

5. The facts upon which petitioner relies as the basis of this proceeding are as follows:

(a) During the years 1925, 1926 and 1927 Petroleum Exploration drilled a number of productive oil wells, and charged the cost of such wells to capital account. In preparing "Form O" for these years, the cost of these wells was added to the equipment schedules, and depreciation computed thereon. The Commissioner, however, insists that the cost of these wells should be added to the leasehold schedules and returned by depletion. By such (18) action the Commissioner penalizes the petitioner, inasmuch as depletion has been computed on a percentage basis, 27½ per cent of gross income, or 50 per cent of net income, and is not in any way increased by the addition of the drilling costs to the depletion schedules; whereas, when such drilling costs are added to the depreciation schedules, an additional depreciation deduction does result.

6. Wherefore the petitioner prays that the Board may hear the proceeding and prays for relief from the deficiency asserted by the respondent on the following and each of the following particulars:

(a) That the Board find that the capitalized cost of drilling productive oil wells should be returned as depreciation and not as depletion and that the depreciation allowance for Petroleum Exploration, on such wells and associated equipment, for 1927, should be $75,427.20.

(b) And such other and further relief as the nature of the case may require.

LELAND E. FISKE, C. P. A.,
Counsel for Petitioner,
1181 North Boston Ave.,
Tulsa, Okla.

STATE OF WEST VIRGINIA,
County of Tyler, ss:

E. A. Durham, being duly sworn, says that he is the president of the above named petitioner; that he is duly authorized to verify the foregoing petition; that he has read the foregoing petition, or had same read to him, and is familiar with the statements contained therein, and that the facts stated are true, except as to those facts stated to be upon information and belief, and those facts he believes to be true.

E. A. DURHAM.

Subscribed and sworn to before me this 20 day of June 1930.

J. E. FETTY,
Notary Public.

(Notary's Seal)

My Commission Expires Nov. 8, 1937.

EXHIBIT A.

Treasury Department
Washington

(19) June 13, 1930.

Office of Commisioner
of Internal Revenue
IT:AR:G-3:GB.

Petroleum Exploration, Incorporated,
Trico Bldg.,
Sistersville, West Virginia.

Sirs:

You are advised that the determination of your tax liability for the year 1927 discloses a deficiency of $4,-404.21, as shown in the statement attached.

In accordance with section 274 of the Revenue Act of 1926, notice is hereby given of the deficiency mentioned. Within sixty days (not counting Sunday as the sixtieth day) from the date of the mailing of this letter, you may petition the United States Board of Tax Appeals for a redetermination of your tax liability.

HOWEVER, IF YOU DO NOT DESIRE TO PETITION, you are requested to execute the enclosed agreement form and forward it to the Commissioner of Internal Revenue, Washington, D. C., for the attention of IT:C:P-7. The signing of this agreement will expedite the closing of your return by permitting an early assessment of any deficiency and preventing the accumulation of interest charges, since the interest period terminates thirty days after filing the enclosed agreement, or on the date assessment is made, which ever is earlier; WHEREAS IF NO AGREEMENT IS FILED, interest will accumulate to the date of assessment of the deficiency.

Respectfully,

ROBT. H. LUCAS, Commissioner,
By DAVID BURNET,
Deputy Commissioner.

Enclosures:
Statement
Form 882
Form 870
Schedules 1 to 4, incl.

(20) IT:AR:G—3:CB.

Statement of Returns Examined,
and
Resulting Tax Liability.

Returns Examined

Parent or Principal Company	*Year*	*Form*
Petroleum Exploration, Incorporated, Sistersville, West Virginia	1927	1120 Consolidated
Subsidiary		
Petroleum Purchasing Company Sistersville, West Virginia	1927	1122

Tax Liability

Petroleum Exploration, Incorporated.

Year	Corrected Tax Liability	Tax Previously Assessed	Over-Assessment	Deficiency
1927	$30,524.10	$26,119.89	0.00	$4,404.21

Revenue Agent's report covering the year 1927, a copy of which has been furnished you, has been used as the basis of this examination.

Consistent with the findings of this office for the year 1926, the Revenue Agent's report is sustained in the disallowance of the item of Bad Debts, $20,812.27, and your contention in your protest against the Revenue Agent's report is denied that you be allowed a deduction of this amount representing seventy-five per cent of the Southern Petroleum Exploration's loss for the year 1927.

The item of $1,433.19 deducted and disallowed as being prior years expense has been allowed based upon statement contained in your protest mentioned above.

The deficiency and/or overassessment set forth herein has been allocated to Petroleum Exploration, Incorporated.

Preliminary thirty-day letter was mailed, dated April 16, 1930, and protest thereto was filed, dated May 16, 1930.

The returns for the years 1925 and 1926 are before the Board of Tax Appeals on appeal Docket Number 43480, involving the same points as are in dispute for the present year 1927.

(21) Petroleum Exploration, Incorporated

Year ended December 31, 1927.

Schedule 1

Net Income

Net income as disclosed by books		247,854.04
As corrected		172,500.55
Net adjustment		75,353.49
Unallowable deductions and additional income:		
(a) Income Tax Reserve	24,852.67	
(b) Bad Debts disallowed	20,812.27	
(c) Legal Costs Capitalized	300.00	
(d) Profit on Sale of Auto	350.00	
(e) Depreciation on lease equipment	10,191.23	
(f) Depreciation on other assets	1,673.59	
(g) Depletion disallowed	490.95	
Total		58,670.71
Nontaxable income and additional deductions:		
(h) Bad Debts deducted on return	812.27	
(i) Depletion on appreciation	133,211.93	
Total		134,024.20
Net Adjustment as Above		75,353.49

Explanation of Items Changed.

(a) Income Tax Reserve	24,852.67
(h) Bad Debts	812.27
(i) Depletion on Appreciation	133,211.93

The above three adjustments appear on the original return filed, resulting in a net income of $138,682.51 as shown by the return. These adjustments have been approved by the Bureau.

(b) Bad Debts disallowed 20,812.27

This amount represents three-fourths of Southern Petroleum Exploration's loss for 1927. The two corporations are not affiliated for income tax purposes. It is shown that $20,000.00 of the amount disallowed was credited to the Bad Debt Reserve. The balance of $812.27 was taken as an additional deduction on the return.

The Petroleum Exploration Company owns three-fourths of the Capital Stock of the Southern Petroleum Exploration. Its advances to the end of the taxable year amounted to $164,187.03. A similar deduction was disallowed in the examination for 1926, as Section 214, relied upon by you does not permit a stockholder to deduct its proportionate share of the deficit of a corporation in which it holds stock. Southern Petroleum Exploration is still in business and has some producing wells. It also has assets from which recovery in part is possible.

(22) (c) Legal costs capitalized 300.00

Legal costs in connection with the M. P. G. tract have been set up as a deferred legal charge pending the outcome of litigation. This amount represents the costs of reviewing a bond in connection with the proceedings. It has been capitalized as it relates to the same subject matter, the legal costs of which has been treated in this manner. You have filed no protest against this adjustment.

(d) Profit on the sale of automobile 350.00

This amount represents the sale price of a Buick automobile used at the Montana branch. It was credited to the auto account. The records show that no Buick automobile was bought for this branch after 1921. The previous Revenue Agent's reports show that the item was fully depreciated prior to the taxable year so that the entire sales price is taxable income.

(e) Depreciation on lease equipment 10,191.23

This amount has been computed as follows, taking into consideration your protest dated January 30, 1929:

Depreciation deducted on Return
In operating expenses 86,475.55

In administrative expenses	3,854.60	
Carbon Black Plant	4,684.41	
Total amount deducted		95,014.56
Less:		
Depreciation on Miscellaneous Assets	18,957.42	
Depreciation on Land Department cars capitalized on books and not claimed on the return	150.00	18,807.42
Depreciation of Lease Equipment		76,207.14
Amount allowed by the Bureau		66,015.91
Amount disallowed as excessive		10,191.23

(f) Depreciation on other assets 1,673.59

This amount was computed as follows:

Depreciation deducted on return	18,807.42	
Amount allowed as computed by the Revenue Agent and accepted by the Bureau	17,133.83	
Amount disallowed		1,673.59

(g) Depletion disallowed 490.95

A depletion rate has been established by the Bureau upon the basis of information submitted by you and other data on hand in this office.

(23) (g) Continued.

Depletion deducted on return		
Depletion on cost	36,153.43	
Depletion on appreciation	133,211.93	
Total deducted		169,365.36
Amount allowed by the Bureau		168,874.41
Amount disallowed		490.95

Schedule 2

Petroleum Purchasing Company.

Net Income

Net income as disclosed by books		12,438.88
As corrected		12,180.38
Net adjustment		258.50
Nontaxable income and additional deductions:		
(a) Adjusting inventory, Dec. 31, 1927	241.28	
(b) Difference in opening inventory	3.39	
(c) Reduction in closing inventory	13.83	
Total		258.50

Schedule 3

Petroleum Exploration, Incorporated

Consolidated Net Income, 1927

Net income as corrected		
Petroleum Exploration, Incorporated	172,500.55	
Petroleum Purchasing Company	12,180.38	
Intercompany Inventory Loss	41,423.53	
Total		226,104.46

Schedule 4

Computation of Tax
Income Tax

Net income for taxable year, subject to tax		266,104.46
Income tax at 13½ percent		30,524.10
Total tax assessable	30,524.10	
Tax previously assessed	26,119.89	
Additional tax to be assessed		4,404.21

ANSWER.

(24) Filed Aug. 5, 1930.

UNITED STATES BOARD OF TAX APPEALS.

Petroleum Exploration, Petitioner,
vs.
Commissioner of Internal Revenue,
Respondent.
} Docket No. 49339

The Commissioner of Internal Revenue by his attorney, C. M. Charest, General Counsel, Bureau of Internal Revenue, for answer to the petition of the above named taxpayer, admits and denies as follows:

1. Admits the allegations contained in Paragraph 1.

2. Admits that the notice of deficiency was mailed to the petitioner on June 13, 1930.

3. Admits the allegations contained in Paragraph 3.

4 (a). Denies that the Commissioner has committed any error as alleged in Paragraph (4a).

5 (a). Denies the allegations contained in Paragraph 5 (a).

6. Denies generally and specifically each and every allegation contained in taxpayer's petition and not hereinbefore admitted, qualified, or denied.

Wherefore, it is prayed that the taxpayer's appeal be denied.

(Signed) C. M. CHAREST,
General Counsel,
Bureau of Internal Revenue.

Of Counsel:

EUGENE MEACHAM,
C. E. LOWERY,
Special Attorneys,
Bureau of Internal Revenue.

MOTION TO CONSOLIDATE.

(25) Filed Sep. 12, 1930.

UNITED STATES BOARD OF TAX APPEALS.

Petroleum Exploration, Petitioner,
vs.
Commissioner of Internal Revenue, Respondent.
} Docket No. 43480

Comes now the above named taxpayer by its counsel Robert Ash and T. J. Reilly and moves that this case be consolidated with Docket No. 49339.

The reasons for this motion are: Docket No. 49339 is for the taxable year 1927 and presents an issue regarding depreciation. This is the only issue in the case. In Docket No. 43480 the identical question is presented for the years 1925 and 1926. To try these cases on separate records would serve no useful purpose.

Wherefore, it is prayed that this motion be granted.

ROBERT ASH,
T. J. REILLY,
Munsey Building,
Washington, D. C.
Attorneys for Petitioner.

Granted Sep. 27, 1930.

(Signed) PERCY W. PHILLIPS,
U. S. Board of Tax Appeals.

FINDINGS OF FACT AND OPINION.

(26) 23 B. T. A. ——.

UNITED STATES BOARD OF TAX APPEALS.

Petroleum Exploration, Petitioner,
vs.
Commissioner of Internal Revenue, Respondent.

Docket Nos. 43480, 49339. Promulgated June 29, 1931.

Deduction—Depreciation. Amounts expended by petitioner during 1925, 1926 and 1927, representing cost of drilling productive oil wells, of freight and haulage and of labor employed in installing equipment in the wells, all of which cost was capitalized, *held*, to be recoverable through depreciation rather than depletion. *A. T. Jergins Trust*, 22 B. T. A. 551, followed.

Robert Ash, Esq., T. J. Reilly, Esq., and *Leland E. Fiske, C. P. A.*, for the petitioner. *Eugene Meacham, Esq.*, for the respondent.

In these proceedings, consolidated for hearing, the respondent has determined income tax deficiencies in the amounts of $10,262.26, $7,040.24 and $4,404.21 for the calendar years 1925, 1926 and 1927, respectively, and the sole issue presented for our determination is raised by petitioner's contention that the capitalized cost of drilling oil wells, of haulage and of installing equipment in the wells, is recoverable through depreciation instead of through depletion as determined by respondent. The petitioner abandoned the issue relative to a claimed bad debt deduction for 1926.

FINDINGS OF FACT.

(27) The petitioner is a corporation organized on September, 25, 1916, under the laws of the State of Maine, and its principal office is at Sistersville, W. Va.

The petitioner is the parent company of the following subsidiaries:

Petroleum Purchasing Company, organized on April 1, 1924, under the laws of Delaware, with principal office at Sistersville. Western Petroleum Exploration, organized on June 7, 1921, under the laws of Maine, with principal office at Sistersville.

The parties hereto have submitted the following stipulation of facts:

1. On December 31, 1924, the undepreciated investment of Petroleum Exploration in equipment in oil wells amounted to $475,975.02.

2. During the years 1925, 1926 and 1927 Petroleum Exploration capitalized on its books of account the total cost of new productive oil wells drilled, such charges representing amounts paid for equipment put into the wells, amounts paid to drilling contractors for drilling the wells, amounts paid for freight and haulage of the equipment, and amounts paid for labor in installing the equipment in the wells, as follows:

Year	Cost of Equipment	Cost of Drilling Wells, Hauling & Placing Equipment	Total Cost of Completed Producing Wells
1925	$121,303.03	$49,640.17	$170,943.20
1926	15,882.88	52,994.14	68,887.02
1927	56,626.31	2,659.26	59,285.57

3. The productive life of all producing wells, the total cost of which was capitalized as shown in paragraph No. 2, is more than one year.

4. Depreciation has been claimed by the petitioner and allowed by the Commissioner at a unit production rate, based on the length of life of the oil deposits.

5. The Commissioner, in making his computation of depreciation, has added to his depreciation schedules the cost of the equipment added each year, as shown in paragraph No. 2, but has not added the cost of drilling wells, hauling and placing the equipment.

(28) 6. Instead, the cost of drilling wells, hauling and placing the equipment, as shown in paragraph No. 2, has been added to the cost depletion schedules by the Commissioner; but depletion has been allowed on a statutory percentage basis (27½ per cent of gross income, not to exceed 50 per cent of net income) and is not based on cost.

7. The petitioner, in making its computation of de-

preciation as shown in its "Form O", has added the total cost of completed wells, including equipment, drilling, hauling and placing the equipment, to its depreciation schedules, no part of the cost of the wells being added to the cost depletion schedules.

8. If petitioner's method of computing depreciation be sustained by the Board, namely, by adding to the undepreciated investment shown in paragraph No. 1 the total cost of completed wells as shown in paragraph No. 2 (no part of such cost being added to the depletion schedules) an increase in the depreciation allowance will result as follows:

DEPRECIATION ALLOWANCE

Year	Computed by Commissioner's Method	Computed by Petitioner's Method	Increase in Depreciation Allowance if Petitioner's Method be sustained
1925	$82,826.35	$89,369.57	$ 6,543.22
1926	68,105.24	78,192.46	10,087.22
1927	66,015.91	75,161.03	9,145.12

9. If petitioner's method of computing depreciation be sustained, as shown in paragraph No. 8, a decrease in the depletion allowance will result as follows:

DEPLETION ALLOWANCE

Year	Computed by Commissioner's Method	Computed by Petitioner's Method	Decrease in Depletion Allowance if Petitioner's Method be sustained
1925	$302,012.87	$300,860.43	$1,152.44
1926	277,900.70	275,191.94	2,708.76
1927	168,874.41	167,486.55	1,387.86

OPINION.

(29) TRUSSELL: In the case of *A. T. Jergins Trust*, 22 B. T. A. 551, we held, under the applicable provisions of the Revenue Acts of 1921 and 1924, that capitalized

expenditures of the type involved in the instant case, are recoverable through depreciation rather than depletion. The instant case involves the years 1925, 1926 and 1927 and the applicable provisions of the 1926 Act are to the same effect as those of the 1924 Act. Accordingly, our decision in *A. T. Jergins Trust, supra,* is controlling and upon authority of that decision the petitioner's contention is sustained and the respondent's determination reversed.

Judgment will be entered pursuant to Rule 50.

(30) **DECISION.**

UNITED STATES BOARD OF TAX APPEALS.

Petroleum Exploration, Petitioner,
vs.
Commissioner of Internal Revenue, Respondent.
} Docket Nos. 43480, 49339.

The Board having heretofore under date of June 29, 1931, promulgated its findings of fact and opinion herein directing that decision be entered under Rule 50, and counsel for respondent having filed a motion for recall and reconsideration of said findings of fact and opinion, and counsel for petitioner having filed a proposed recomputation of the deficiencies as redetermined under the aforesaid findings of fact and opinion, and hearing on said motion for recall and reconsideration and said proposed recomputation having been had pursuant to due notice, and due consideration having been given to said motion and said recomputation it is

Ordered, that said motion for recall and reconsideration of the findings of fact and opinion be and the same is hereby denied, and it is further

Ordered and Decided, that the deficiencies for the years 1925, 1926 and 1927 are $9,561.45, $6,044.15 and $3,356.98, respectively.

(Seal) (Signed) C. M. TRAMMELL, Member.

Entered Aug. 27, 1931.

Certified Copy sent to each party.

PETITION FOR REVIEW AND ASSIGNMENTS OF ERROR.

(31) Filed Feb. 9, 1932.

IN THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT.

David Burnet, Commissioner of Internal Revenue, Petitioner,
vs.
Petroleum Exploration, Respondent.

Docket Nos. 43480 & 49339.

To the Honorable Judges of the United States Circuit Court of Appeals for the Fourth Circuit:

Now Comes David Burnet, Commissioner of Internal Revenue, by his attorneys, G. A. Youngquist, Assistant Attorney General, C. M. Charest, General Counsel, Bureau of Internal Revenue, and Chester A. Gwinn, Special Attorney, Bureau of Internal Revenue, and respectfully shows:

I.

That he is the duly appointed, qualified, and acting Commissioner of Internal Revenue, appointed and holding his office by virtue of the laws of the United States; that the Petroleum Exploration is a corporation organized on September 25, 1916, under the laws of Maine with principal office at Sisterville, West Virginia. That the income tax returns of said corporation for the calendar years 1925, 1926, and 1927 were made to the Collector of Internal Revenue for the district of West Virginia whose office is located in Parkersburg, West Virginia, which is within the jurisdiction of the United States Circuit Court of Appeals for the Fourth Circuit.

II.

(32) The nature of the controversy is as follows, to-wit:

The question upon which the petitioner seeks review

by this court is whether the respondent is entitled to recover capitalized intangible expenses such as wages, fuel, repairs, hauling, etc., in connection with the exploration, development, and drilling of oil wells (such expenses not being represented by physical property) through annual deductions for depletion as provided by Article 223 of Regulations 69 (promulgated under the Revenue Act of 1926) or through annual deductions for depreciation as decided by the Board of Tax Appeals.

On December 31, 1924, the undepreciated investment of the taxpayer in equipment in oil wells amounted to $475,975.02. During the years 1925, 1926, and 1927 the taxpayer capitalized on its books of account the total cost of new productive oil wells drilled, such charges representing amounts paid for equipment put into the wells, amounts paid to drilling contractors for drilling the wells, amounts paid for freight and haulage of the equipment, and amounts paid for labor in installing equipment as follows:

Year	Cost of Equipment	Cost of Drilling Wells, Hauling & Placing Equipment	Total Cost of Completed Producing Wells
1925	$121,303.03	$49,640.17	$170,943.20
1926	15,882.88	52,994.14	68,887.02
1927	56,626.31	2,659.26	59,285.57

It was stipulated by the parties and found by the Board of Tax Appeals that the productive life of all producing wells, the total cost of which was capitalized as stated above, is more than one year. That the taxpayer claimed and the Commissioner allowed deductions for (33) depreciation on said capital investment at a unit production rate, based on the life of the oil deposits; that the Commisioner in computing depreciation included the cost of equipment added each year, as shown above, but did not include the cost of drilling wells, hauling and placing the equipment.

It was further agreed and found by the Board that the cost of drilling wells, hauling and placing the equipment, as shown in the above table of costs, was added to the cost depletion schedules computed by the Commis-

sioner and depletion thereon was allowed on a statutory percentage basis (27½ per cent of gross income, not to exceed 50 per cent of net income) and not upon cost. The taxpayer in computing depreciation added the total cost of completed wells, including equipment, drilling, hauling, and placing the equipment to its depreciation schedules, no part of the cost of the wells being added to the cost depletion schedules.

If the taxpayer is permitted to add the intangible cost of oil wells, including drilling, hauling, and placing of the equipment, to its depreciation schedules and take annual deductions thereon at the rates allowed for depreciation of its physical property the deductions will be larger and its net income for the years involved correspondingly smaller as shown by the Board's findings of fact.

Upon audit of the taxpayer's income tax returns for the years 1925, 1926 and 1927 the Commissioner determined deficiencies for said years in the respective amounts of $10,262.26, $7,040.24 and $4,404.21 whereupon the taxpayer filed its petitions in the Board of Tax Appeals alleging that the Commissioner committed the following errors:

(34) (a) In refusing to add to taxpayer's depreciation schedules for the years 1925, 1926 and 1927 the cost of productive oil wells capitalized on its books and allow a deduction for depreciation thereon.

(b) In refusing to allow as a deduction for bad debt that part of a loan from the Petroleum Exploration to Southern Petroleum Exploration which was alleged to have been determined to be worthless and charged off during the year 1926.

At the hearing respondent abandoned alleged error (b) and submitted the case to the Board on question (a) alone.

The case was heard by a division of the Board on December 2, 1930, and on June 29, 1931, the Board promulgated its findings of fact and opinion in which it was held that the capitalized expenditures of the type involved in this case are recoverable through depreciа-

tion as contended by the taxpayer rather than through depletion as provided by the Commissioner's regulations.

Thereafter, on August 27, 1931, the Board entered its decision and order of redetermination finding that the deficiencies for the years 1925, 1926, and 1927 are $9,561.45, $6,044.15 and $3,356.98, respectively.

III.

That said Commissioner being aggrieved by the findings of fact and by the conclusions of law contained in said decision and by the said order of redetermination desires to obtain a review thereof by this honorable Court. The Commissioner's assignments of error are as follows:

1. The Board erred in holding that the capitalized intangible cost, including haulage and installation of equipment of drilling oil wells is recoverable by annual deductions for depreciation instead of annual deductions for depletion.

2. The Board erred in its construction of Article 223 of Regulations 69 established under the Revenue Act of 1926.

(35) 3. The Board erred in failing to hold that the capitalized intangible cost of drilling oil wells (including hauling and installing equipment) not represented by physical property is returnable through annual deductions for depletion as provided by Article 223 of Regulations 69.

4. The Board erred in failing to find the deficiencies for the years 1925, 1926 and 1927 in the amounts determined by the Commissioner in his 60-day letters to the taxpayer dated March 6, 1929, and June 13, 1930, i. e., in the amounts of $10,262.26, $7,040.24, and $4,404.21 for the years 1925, 1926 and 1927, respectively.

Wherefore, the Commissioner petitions that the decision of the Board of Tax Appeals be reviewed by the United States Circuit Court of Appeals for the Fourth

Circuit, that a transcript of the record be prepared in accordance with law and with the rules of said Court and transmitted to the clerk of said Court for filing, and that appropriate action be taken to the end that the errors complained of may be reviewed and corrected by said court.

(Sgd) G. A. YOUNGQUIST,
Assistant Attorney General.
(Sgd) C. M. CHAREST,
General Counsel,
Bureau of Internal Revenue.

Of Counsel:

CHESTER A. GWINN,
Special Attorney,
Bureau of Internal Revenue.

UNITED STATES OF AMERICA,
(36) District of Columbia, ss:

C. M. CHAREST, being duly sworn, says that he is General Counsel of the Bureau of Internal Revenue and as such is duly authorized to verify the foregoing petition for review; that he has read said petition and is familiar with the contents thereof; that said petition is true of his own knowledge except as to the matters therein alleged on information and belief, and as to those matters he believes it to be true.

(Sgd) C. M. CHAREST.

Subscribed and sworn to before me this 9th day of February, 1932.

(Sgd) GEORGE W. KREIS,
Notary Public.

My commission expires Nov. 12, 1932.

CAG:tco
2-5-32

PRAECIPE FOR RECORD.

(37) Filed April 28, 1932.

IN THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT.

David Burnet, Commissioner of Internal Revenue, Petitioner, *vs.* Petroleum Exploration, Respondent.	Docket Nos. 43480 & 49339.

To the Clerk of the United States Board of Tax Appeals:

You are requested to prepare and transmit to the Clerk of the United States Circuit Court of Appeals for the Fourth Circuit a transcript of the record in the above entitled cases including the following:

1. Docket entries of proceedings before the Board.

2. All pleadings before the Board including,

(a) Petition filed April 4, 1929, Docket No. 43480.

(b) Petition filed June 23, 1930, Docket No. 49339.

(c) Answer filed May 27, 1929, Docket No. 43480.

(d) Answer filed August 5, 1930, Docket No. 49339.

3. Order of Board entered September 27, 1930, consolidating Docket Nos. 43480 and 49339.

4. Findings of fact and opinion of Board promulgated June 29, 1931.

5. Board's decision and order of redetermination entered August 27, 1931.

6. Petition for review.

7. This praecipe.

The foregoing to be prepared, certified and transmitted on or before May 9, 1932 as required by law and the rules of the United States Circuit Court of Appeals for the Fourth Circuit.

(Signed) C. M. CHAREST,
General Counsel,
Bureau of Internal Revenue.

Service of a copy of the within praecipe is hereby admitted this 26th day of April, 1932.

ROBERT ASH,
Attorney for Respondent.

tco 4-14-32

CERTIFICATE.

(38)

Commissioner of Internal Revenue, Petitioner,
vs.
Petroleum Exploration, Respondent.

Docket Nos. 43480 and 49339.

I, B. D. Gamble, Clerk of the U. S. Board of Tax Appeals, do hereby certify that the foregoing pages 1 to 37, inclusive, contain and are a true copy of the transcript of record, papers and proceedings on file and of record in my office as called for by the Praecipe in the appeal (or appeals) as above numbered and entitled.

In testimony whereof, I hereunto set my hand and affix the seal of the United States Board of Tax Appeals, at Washington, in the District of Columbia, this 5th day of May, A. D., 1932.

(Seal) B. D. GAMBLE, Clerk.

Richmond Press, Inc.,
Richmond, Va.
5-22-31—65

PROCEEDINGS IN THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT

No. 3316

DAVID BURNET, Commissioner of Internal Revenue, Petitioner,

versus

PETROLEUM EXPLORATION, Respondent

On Petition to Review the Decision of the United States Board of Tax Appeals

May 7, 1932, the transcript of record is filed and the cause docketed.

May 7, 1932, motion and order extending the time to May 9, 1932, within which to complete the record and transmit same to this Court are filed.

Same day, the appearance of G. A. Youngquist, Assistant Attorney General, is entered for the petitioner.

May 12, 1932, the appearance of Sewall Key, Special Assistant to the Attorney General; C. M. Charest, General Counsel, Bureau of Internal Revenue, and Mason B. Leming, Special Attorney, Bureau of Internal Revenue, is entered for the petitioner.

May 19, 1932, the appearance of Robert Ash is entered for the respondent.

May 24, 1932, stipulation of attorneys to place the case at the foot of the docket for argument at the June term, 1932, is filed.

May 25, 1932, twenty-five copies of the printed record are filed.

June 27, 1932, the appearance of Andrew D. Sharpe, Special Assistant to the Attorney General, is entered for the petitioner.

ARGUMENT OF CAUSE

June 29, 1932, (June term, 1932) cause came on to be heard before Northcott and Soper, Circuit Judges, and Glenn, District Judge, and is argued by counsel and submitted.

UNITED STATES CIRCUIT COURT OF APPEALS, FOURTH CIRCUIT

No. 3316

DAVID BURNET, Commissioner of Internal Revenue, Petitioner,

versus

PETROLEUM EXPLORATION, Respondent

On Petition to Review the Decision of the United States Board of Tax Appeals

(Argued June 29, 1932. Decided October 3, 1932)

Before Northcott and Soper, Circuit Judges, and Glenn, District Judge

Andrew D. Sharpe, Special Assistant to the Attorney General (G. A. Youngquist, Assistant Attorney General; Sewall Key, Special Assistant to the Attorney General; C. M. Charest, General Counsel, Bureau of Internal Revenue, and Chester A. Gwinn and Charles E. Lowrey, Special Attorneys, Bureau of Internal Revenue, on brief), for Petitioner, and Robert Ash (Leland E. Fiske on brief) for Respondent.

OPINION—Filed October 3, 1932

NORTHCOTT, Circuit Judge:

This is a petition to review a decision of the United States Board of Tax Appeals reported in 23 B. T. A. 890.

The pertinent facts, about which there is no dispute, as found by the Board of Tax Appeals, are as follows:

"The petitioner (the taxpayer) is a corporation organized on September 25, 1916, under the laws of the State of Maine, and its principal office is at Sistersville, W. Va.

* * * * * * *

"The parties hereto have submitted the following stipulation of facts:

" '1. On December 31, 1924, the undepreciated investment of Petroleum Exploration in equipment in oil wells amounted to $475,975.02.

" '2. During the years 1925, 1926 and 1927 Petroleum Exploration capitalized on its books of account the total cost of new productive oil wells drilled, such charges representing amounts paid for equipment put into the wells, amounts paid to drilling contractors for drilling the wells, amounts paid for freight and haulage of the equipment, and amounts paid for labor in installing the equipment in the wells, as follows:

"'Year	Cost of equipment	Cost of drilling wells, hauling & placing equipment	Total cost of completed producing wells
1925	$121,303.03	$49,640.17	$170,943.20
1926	15,882.88	52,994.14	68,887.02
1927	56,626.31	2,659.26	59,285.57

" '3. The productive life of all producing wells, the total cost of which was capitalized as shown in paragraph No. 2, is more than one year.

" '4. Depreciation has been claimed by the petitioner and allowed by the Commissioner at a unit production rate, based on the length of life of the oil deposits.

" '5. The Commissioner, in making his computation of depreciation, has added to his depreciation schedules the cost of the equipment added each year, as shown in paragraph No. 2, but has not added the cost of drilling wells, hauling and placing the equipment.

" '6. Instead, the cost of drilling wells, hauling and placing the equipment, as shown in paragraph No. 2, has been added to the cost depletion schedules by the Commissioner; but depletion has been allowed on a statutory percentage basis (27½ per cent of gross income, not to exceed 50 per cent of net income) and is not based on cost.

" '7. The petitioner, in making its computation of depreciation as shown in its "Form O", has added the total cost of completed wells, including equipment, drilling, hauling an placing the equipment, to its depreciation schedules, no part of the cost of the wells being added to the cost depletion schedules.

"'8. If petitioner's method of computing depreciation be sustained by the Board, namely, by adding to the undepreciated investment shown in paragraph No. 1 the total cost of completed wells as shown in paragraph No. 2 (no part of such cost being added to the depletion schedules) an increase in the depreciation allowance will result as follows:

"'Depreciation Allowance

"'Year	"'Computed by Commissioner's method	Computed by petitioner's method	Increase in depreciation allowance if petitioner's method be sustained
1925	$82,826.35	$89,369.57	$6,543.22
1926	68,105.24	78,192.46	10,087.22
1927	66,015.91	75,161.03	9,145.12

"'9. If petitioner's method of computing depreciation be sustained, as shown in paragraph No. 8, a decrease in the depletion allowance will result as follows:

"'Depletion Allowance

"'Year	"'Computed by Commissioner's method	Computed by petitioner's method	Decrese in depletion allowance if petitioner's method be sustained
1925	$302,012.87	$300,860.43	$1,152.44
1926	277,900.70	275,191.94	2,708.76
1927	168,874.41	167,486.55	1,387.86"

The Statutes and Treasury Regulations involved are:

"Revenue Act of 1926, c. 27, 44 Stat. 9

"Sec. 204. (c) The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the same as is provided in subdivision (a) or (b) for the purpose of determining the gain or loss upon the sale or other disposition of such property, except that—

* * * * * * *

"(2) In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income

from the property during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph.

"Sec. 234. (a) In computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:

* * * * * * *

"(7) A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence;

"(8) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary. In the case of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee;

"Treasury Regulations 69"

"Art. 221. Depletion in the case of oil and gas wells.—Under section 204 (c) (2), in the case of oil and gas wells, a taxpayer may deduct for depletion an amount equal to 27½ per cent of the gross income from the property during the taxable year, but such deduction shall not exceed 50 per cent of the net income of the taxpayer (computed without allowance for depletion) from the property. In no case shall the deduction computed under this paragraph be less than it would be if computed upon the basis of the cost of the property, or its value at the basic date, as the case may be. In general, "the property", as the term is used in section 204 (c) (2) and this article, refers to the separate tracts or leases of the taxpayer.

"Art. 223. Charges to capital and to expense in case of oil and gas wells.—Such incidental expenses as are paid for

wages, fuel, repairs, hauling, etc., in connection with the exploration of the property, drilling of wells, building of pipe lines, and development of the property may, at the option of the taxpayer, be deducted as a development expense or charged to capital account returnable through depletion. If in exercising this option the taxpayer charges these incidental expenses to capital account, in so far as such expense is represented by physical property it may be taken into account in determining a reasonable allowance for depreciation. The cost of drilling non-productive wells may at the option of the operator be deducted from gross income as a development expense or charged to capital account returnable through depletion and depreciation as in the case of productive wells.

An election once made under the provisions of this article will control the taxpayer's returns for all subsequent years. Where deductions for depreciation or depletion have either on the books of the taxpayer or in his returns of net income been included in the past in expense or other accounts, rather than specifically as depreciation or depletion, or where capital expenditures have been charged to expense in lieu of depreciation or depletion, a statement indicating the extent to which this practice has been carried should accompany the return.

"Art. 225. Depreciation of improvements in the case of oil and gas wells.—Both owners and lessees operating oil and/or gas properties will, in addition to and apart from the deduction allowable for depletion as hereinbefore provided, be permitted to deduct a reasonable allowance for depreciation of physical property, such as machinery, tools, equipment, pipes, etc., so far as not in conflict with the option exercised by the taxpayer under article 223. The amount deductible on this account shall be such an amount based upon its cost or other basis equitably distributed over its useful life as will bring such property to its true salvage value when no longer useful for the purpose for which such property was acquired. Accordingly, where it can be shown to the satisfaction of the Commissioner that the reasonable expectation of the economic life of the oil or gas deposit with which the property is connected is shorter than the normal useful life of the physical property, the amount annually deductible for depreciation on such property may be based upon the length of life of the deposit."

The sole question presented is whether the capitalized cost of drilling oil wells and of hauling and placing equipment in the wells is recoverable through allowances for depreciation or depletion. The Commissioner of Internal Revenue determined that this cost was properly recoverable through an allowance for depletion. Upon hearing before the Board of Tax Appeals this determination of the Commissioner was reversed.

The Treasury regulations cited above are authorized by Congress, and while the Secretary of the Treasury cannot by a regulation alter or amend the law (South Carolina Produce Ass'n v. Commissioner, 50 Fed. (2) 742), if within and in accordance with the acts of Congress such regulations have all the force and effect of statutes.

Burnet v. Moore Cotton Mills Co., 49 Fed. (2) 59, and authorities there cited.

Brewster v. Gage, 280 U. S. 327.

Fawcus Machine Co. v. United States, 282 U. S. 375.

It has been repeatedly held by this court, and there is no authority to the contrary, that the action of the Commissioner of Internal Revenue in determining a tax assessment is prima facie correct, and the burden is on the objecting taxpayer to show the action of the Commissioner to be erroneous.

Lehman v. Tait, 58 Fed. (2) 20, and authorities there cited.

Here the taxpayer was given the option under the provisions of Article 223 of Regulations 69 to either charge the expenditures in question to development expense or charge them to capital account *returnable through depletion.* (Italics ours.) This option was exercised by the taxpayer by charging the expenditures to capital account, and by so acting the taxpayer must have done so with the full knowledge that such sums so charged must come back through depletion and not depreciation. This is the plain provision of the Regulation.

It is true that Article 225 of Regulations 69 permits an allowance for depreciation of physical property, but only so far as not to conflict with the option exercised by the taxpayer as to charging such expenditures to capital account, and such allowance is given only for such physical property as "machinery, tools, equipment, pipes, etc." The hole of an oil well itself certainly would not come within this classification, and could not be held to be physical property.

We are here concerned with the cost of putting down the hole through which oil is recovered from under the ground. In the oil well the hole in the ground performs a function, with respect to the oil brought out of the well, similar to that performed by the shaft or tunnel in a mine with respect to the ore brought out of the ground. Neither the shaft nor the hole can be, strictly speaking, termed improvements. They simply serve as conduits through which the mineral is recovered. The bare hole in an oil well does not deteriorate or depreciate as does a piece of machinery or as does the casing with which it is lined, and has no service life other than the period necessary to exhaust the body of the mineral which it reaches. Once the mineral is exhausted the hole is useless and of no value whatever, such as may be possessed by the casing which may be pulled or the machinery which may be removed to be used elsewhere. It seems to us that the proper and logical method of returning to the taxpayer the expense of drilling the hole is through depletion rather than depreciation, this entirely aside from the implied agreement to accept depletion when the taxpayer exercised the option to charge the expense to capital account.

The allowance for depletion was intended by Congress to restore to the taxpayer his capital investment with respect to the oil and gas wells as that investment is used up or exhaus-ed.

In Lynch, Executrix, v. Alworth-Stephens Co., 267 U. S. 364, the Supreme Court said:

"It is said that the depletion allowance applies to the physical exhaustion of the ore deposits, and since the title thereto is in the lessor, he alone is entitled to make the deduction. But the fallacy in the syllogism is plain. The deduction for depletion in the case of mines is a special application of the general rule of the statute allowing a deduction for exhaustion of property. While respondent does not own the ore deposits, its right to mine and remove the ore and reduce it to possession and ownership is property within the meaning of the general provision. Obviously, as the process goes on, this property interest of the lessee in the mines is lessened from year to year, as the owner's property interest in the same mines is likewise lessened. There is an exhaustion of property in the one case as in the other. * * *"

If the cost of the hole is included in depreciation allowances as well as cost of machinery, tools, etc., which have a service life in no way connected with or dependent upon the length of time it takes to exhaust the mineral, then there is no expense whatever connected with an oil well left to be returned through depletion, and the regulation (Article 223) is robbed of any meaning, except as to the exploration of the property.

In Burnet v. Thompson Oil & Gas Co., 283 U. S. 301, the court said:

"It is clear that Congress intended that the lessee of an oil well should be entitled to a reasonable allowance for depletion based upon cost for March 1, 1913 value. It did not, however, attempt to prescribe a formula for ascertaining it, but expressly delegated that function to the Commissioner of Internal Revenue, who was to make rules and regulations to that end. Pursuant to this authority, regulations were made, which required the deduction of depletion theretofore sustained in ascertaining the capital remaining in any year recoverable by depletion deductions. * * *

"The decision in the Ludey case (United States v. Ludey, 274 U. S. 295) has been adopted in the later statutes as affecting sales of capital assets, but the provisions for annual depletion allowance has remained substantially unchanged. This in itself is persuasive evidence that Congress has approved the executive construction embodied in the regulations."

The long and consistent administrative construction, especially when it is, as here, clearly an admissible one and consistent with the purpose of the statute, should not be set aside unless plainly wrong. Universal Battery Co. v. United States, 281 U. S. 580; Fawcus Machine Co. v. United States, 282 U. S. 375; Williams v. Burnet, Commissioner, 59 Fed. (2) 357.

A consideration of this question leads to the conclusion that the elements calling for both depletion and depreciation are present in an oil well. The outlay for geological study and survey is directly connected with the location or discovery of the oil deposit, and would seem to be not subject in any way to depreciation, but should be allowed

under depletion when capitalized. So with the hole in the ground. It cannot be withdrawn or inventoried as having any independent value or resold as may be done with casing, tools or machinery. As the wages for labor and other expenses in connection with the transportation and work of a geologist in prospecting an oil field are a part of the cost of discovery or development so the wages for labor in drilling a well are such a part of the cost of discovery or development as are not susceptible of depreciation.

Section 204 of the Act of 1926, above set out, provides for "depletion and for depreciation of improvements", and goes on to leave the rules and regulations to be prescribed "by the commissioner with the approval of the secretary". Such rules and regulations have been prescribed and are apparently reasonable and just. Under these regulations, the cost of the drill hole of an oil well, and as it seems to us to be natural, is not subject to depreciation, but should be allowed for, especially when capitalized, under the head of depletion.

The Board of Tax Appeals rests its decision in the instant case on its decision in the case of A. T. Jergens Trust Co., 22 B. T. A. 551, where a similar question was presented; and the Court of Claims in the recent case of Dakota-Montana Oil Co. v. United States (decided July 5, 1932), has by a majority opinion reached the same conclusion as the Board. We are, however, of the opinion that the regulations are reasonable and having been in force for a long time they should be sustained, particularly where the taxpayer, as in this case, availed itself of the identical regulations to capitalize expenditures for intangibles, thus accepting the provision that such expenditures should be returned through allowances for depletion. The taxpayer cannot accept the benefits of the regulation and reject the accompanying obligation.

In conclusion we wish to say that if any of the expense of wages, hauling, etc. in connection with the casing, operating tools, machinery, etc. are included in the Commissioner's allowance for depletion it is our opinion that such expense should be depreciated. It is impossible for us to tell from the record the fact as to this question, but, as to allowances for all expense of putting down the drill hole the Commissioner was right in making such allowances

under the head of depletion. It follows that the decision of the Board of Tax Appeals must be

Reversed.

JUDGMENT—Filed and Entered October 8, 1932

UNITED STATES CIRCUIT COURT OF APPEALS, FOURTH CIRCUIT

No. 3316

DAVID BURNET, Commissioner of Internal Revenue, Petitioner,

vs.

PETROLEUM EXPLORATION, Respondent

On Petition to Review the Decision of the United States Board of Tax Appeals

This cause came on to be heard on the transcript of the record from the United States Board of Tax Appeals, and was argued by counsel.

On consideration whereof, It is now here ordered and adjudged by this Court that the decision of the said Board of Tax Appeals, in this cause, be, and the same is hereby, reversed; and that this cause be, and the same is hereby, remanded to the United States Board of Tax Appeals for further proceedings in accordance with the opinion of the Court filed herein.

October 8, 1932.

Elliott Northcott, U. S. Circuit Judge.

CLERK'S CERTIFICATE

UNITED STATES OF AMERICA.
Fourth Circuit, ss:

I, Claude M. Dean, Clerk of the United States Circuit Court of Appeals for the Fourth Circuit, do certify that the foregoing is a true copy of the record and proceedings in the therein entitled cause, as the same remain among

the records and files of the said Circuit Court of Appeals.

In testimony whereof I hereto set my hand and affix the seal of the said United States Circuit Court of Appeals for the Fourth Circuit, at Richmond, Virginia, this 10th day of October, A. D., 1932.

Claude M. Dean, Clerk U. S. Circuit Court of Appeals, Fourth Circuit. (Seal United States Circuit Court of Appeals, Fourth Circuit.)

(2557)

SUPREME COURT OF THE UNITED STATES

ORDER ALLOWING CERTIORARI—Filed November 14, 1932

The petition herein for a writ of certiorari to the United States Circuit Court of Appeals for the Fourth Circuit is granted, and the case is assigned for argument immediately following the hearing in case No. 434, United States vs. Dakota-Montana Oil Co.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.